

NOTICES OF PROPOSED RULEMAKING

Unless exempted by A.R.S. § 41-1005, each agency shall begin the rulemaking process by first submitting to the Secretary of State's Office a Notice of Rulemaking Docket Opening followed by a Notice of Proposed Rulemaking that contains the preamble and the full text of the rules. The Secretary of State's Office publishes each Notice in the next available issue of the *Register* according to the schedule of deadlines for *Register* publication. Due to time restraints, the Secretary of State's Office will no longer edit the text of proposed rules. We will continue to make numbering and labeling changes as necessary. Under the Administrative Procedure Act (A.R.S. § 41-1001 et seq.), an agency must allow at least 30 days to elapse after the publication of the Notice of Proposed Rulemaking in the *Register* before beginning any proceedings for adoption, amendment, or repeal of any rule. A.R.S. §§ 41-1013 and 41-1022.

NOTICE OF PROPOSED RULEMAKING

TITLE 15. REVENUE

CHAPTER 2. DEPARTMENT OF REVENUE INCOME AND WITHHOLDING TAX SECTION SUBCHAPTER D. CORPORATIONS

PREAMBLE

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| <u>1. Sections Affected</u>
R15-2D-303 | <u>Rulemaking Action</u>
Amend |
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- 2. The specific authority for the rulemaking, including both the authorizing statute (general) and the statutes the rules are implementing (specific):**
Authorizing statute: A.R.S. § 42-1005
Implementing statutes: A.R.S. §§ 43-1121, 43-1122, and 43-1125
- 3. A list of all previous notices appearing in the Register addressing the proposed rule:**
Notice of Rulemaking Docket Opening: 6 A.A.R. 1807, May 19, 2000
Notice of Recodification: 6 A.A.R. 2308, June 23, 2000
- 4. The name and address of agency personnel with whom persons may communicate regarding the rulemaking:**
- | | |
|------------|---|
| Name: | Jim Bilski
Tax Analyst |
| Address: | Tax Research & Analysis Section
Arizona Department of Revenue
1600 West Monroe
Phoenix, AZ 85007 |
| Telephone: | (602) 542-4672 |
| Fax: | (602) 542-4680 |
| E-mail: | BilskiJ@revenue.state.az.us |
- 5. An explanation of the rule, including the agency's reasons for initiating the rule:**
The proposed rule relates to Domestic International Sales Corporations (DISCs) and DISC shareholders. The proposed rule addresses computation of a DISCs income, the combined filing requirements for DISCs, the computation of the addition to income for DISC commissions, the deductibility of the interest charge paid by DISC shareholders, and adjusting DISC transactions that comply with the Internal Revenue Code.
- 6. Reference to any study that the agency relied on in its evaluation of or justification for the proposed rule and where the public may obtain or review the study, all data underlying each study, any analysis of the study and other supporting material:**
None

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7. A showing of good cause why the rule is necessary to promote a statewide interest if the rule will diminish a previous grant of authority of a political subdivision of this state:

Not applicable

8. The preliminary summary of the economic, small business, and consumer impact:

It is expected that the benefits of the rules will be greater than the costs. The amendment of these rules will benefit the public by making the rules conform to current statute, removing language that is obsolete or that is repetitive of statute, and addressing issues that are not covered in the current rule.

The Department, the Governor's Regulatory Review Council, and the Secretary of State's Office will incur the costs associated with the rulemaking process. Taxpayers are not expected to incur any expense in the amendment of these rules.

9. The name and address of agency personnel with whom persons may communicate regarding the accuracy of the economic, small business, and consumer impact statement:

Name: Jim Bilski
Tax Analyst

Address: Tax Research & Analysis Section
Arizona Department of Revenue
1600 West Monroe
Phoenix, AZ 85007

Telephone: (602) 542-4672

Fax: (602) 542-4680

E-mail: BilskiJ@revenue.state.az.us

10. The time, place, and nature of the proceedings for the making, amendment, or repeal of the rule, or if no proceeding is scheduled, where, when, and how persons may request an oral proceeding on the proposed rule:

The Department has not scheduled any oral proceedings. Written comments on the proposed rules or preliminary economic, small business, and consumer impact statements may be submitted to the person listed in paragraphs 4 and 9. Pursuant to A.R.S. § 41-1023(C), the Department will schedule oral proceedings if 1 or more individuals file written requests for oral proceedings within 30 days after the publication of this Notice.

A person may submit written comments regarding the proposed rulemaking action by submitting the comments no later than 5:00 p.m., April 9, 2001, to the person listed in paragraphs 4 and 9.

11. Any other matters prescribed by statute that are applicable to the specific agency or to any specific rule or class of rules:

None

12. Incorporations by reference and their location in the rules:

None

13. The full text of the rules follows:

TITLE 15. REVENUE

**CHAPTER 2. DEPARTMENT OF REVENUE
INCOME AND WITHHOLDING TAX SECTION**

SUBCHAPTER D. CORPORATIONS

ARTICLE 3. SUBTRACTIONS FROM ARIZONA GROSS INCOME

R15-2D-303. Domestic International Sales Corporation (DISC)

ARTICLE 3. SUBTRACTIONS FROM ARIZONA GROSS INCOME

R15-2D-303. Domestic International Sales Corporation (DISC)

- A.** For purposes of this Section, "DISC" means a corporation that elects to be treated as a DISC under Internal Revenue Code § 992. For Arizona state income tax purposes, a DISC ~~will be~~ is treated as an ordinary corporation, ~~and will be required to file an Arizona Corporation Income Tax Return. A corporation which reports as a DISC for federal income tax purposes is~~

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taxable on its net income as a separate entity without reference to its distributions to stockholders. Reference Sections 43-1421(5) and 43-1022(27). The Arizona gross income of a DISC is the DISC's federal taxable income computed as if the DISC were a corporation that had not elected to be treated as a DISC. A DISC that meets the combined return filing requirements under R15-2D-401 shall file as part of a combined return unless:

1. The DISC is a foreign corporation that is not subject to Arizona income tax, or
 2. The corporation, with which the DISC would otherwise be required to file a combined return, is a member of an Arizona affiliated group under A.R.S. § 43-947.
- B.** Shareholders are taxable on the distributed portion of the income earned by the DISC. These distributions are considered dividends to the shareholders. The undistributed portion of the DISC income will be taxable to its shareholders upon distribution in cash or property.
- C.** Dividends received by any shareholder from a corporation which does 50% or more of its business in this state, although considered taxable and reportable on the shareholder's tax return, are deductible in full on the shareholder's return.
- D.** No federal income tax deduction will be allowed to a DISC, since the DISC is not the taxpaying entity under federal law, and therefore does not pay or accrue any federal income taxes.
- E.** For those DISC not dealing at arm's length, the Department may review the transactions between the DISC and its shareholders and make such adjustments under Sections 43-941 and 43-942 as it deems necessary to properly reflect Arizona income.
- B.** A corporation that directly or indirectly owns or controls 50% or more of the voting stock of a DISC shall add to Arizona gross income the amount of commissions, rentals, and other amounts paid or accrued to the DISC that are deducted in computing federal taxable income, unless either subsection (B)(1) or (B)(2) applies.
1. If the corporation and the DISC file as part of the same Arizona combined return, no addition to Arizona gross income is required.
 2. If the DISC is taxable in Arizona and subsection (B)(1) does not apply, the addition to Arizona gross income equals the amount of the commissions, rentals, and other amounts deducted in computing the corporation's federal taxable income minus the quotient of the DISC's Arizona taxable income attributable to the commissions, rentals, and other amounts divided by the corporation's apportionment ratio. In no case shall the addition to Arizona gross income be less than zero.
Example: Corporation A owns 60% of the voting stock of a DISC. Corporation A has a 50% Arizona apportionment ratio and the DISC has a 10% Arizona apportionment ratio for the taxable year. Corporation A and the DISC are not required to file a combined return. Corporation A pays the DISC commissions of \$100,000 and deducts this amount on its federal income tax return. The DISC's Arizona taxable income attributable to the commission is \$10,000 (\$100,000 x 10%). Therefore, Corporation A's addition to Arizona gross income for the DISC commissions is \$80,000 (\$100,000 - (\$10,000 ÷ .50)).
- C.** A corporation that deducts the interest charge required under Internal Revenue Code § 995(f) in determining federal taxable income for the taxable year, shall add to Arizona gross income the amount of the interest charge deducted, unless subsection (C)(1), (C)(2), or (C)(3) applies.
1. If the corporation and the DISC file as part of the same Arizona combined return for the taxable year in which the DISC income related to the interest charge is reported, the corporation shall not add the interest charge to Arizona gross income.
 2. If the interest charge is attributable to DISC commissions, rentals, and other amounts for which an addition to Arizona gross income is required under subsection (B), the corporation shall not add the interest charge to Arizona gross income.
 3. If the interest charge is attributable to income of a DISC the dividends of which are includible in the corporation's Arizona taxable income, the corporation shall not add the interest charge to Arizona gross income.
Example: Corporation B owns 30% of a DISC that is not a foreign corporation. If the DISC dividends are apportionable business income of Corporation B, the interest charge is not added to Arizona gross income.
- D.** The Department shall not adjust DISC transactions that comply with the inter-company pricing provisions of Internal Revenue Code § 994.